[JOINT COMMITTEE PRINT]

OVERVIEW OF THE UNRELATED BUSINESS INCOME TAX ON EXEMPT ORGANIZATIONS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JUNE 22, 25, 26, 29, AND 30, 1987

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 20, 1987

U.S. GOVERNMENT PRINTING OFFICE

74-266 WASHINGTON : 1987 JCS-16-87

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

J 862-24
H782-21

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INTRODUCTION

In general

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled public hearings on June 22, 25, 26, 29, and 30, 1987, on the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code. These organizations include, among others, charitable, educational, scientific, and religious organizations; social welfare organizations; labor or agricultural organizations; trade associations; social clubs; voluntary employee beneficiary associations; and trusts that are part of qualified pension plans. Since 1969, all exempt organizations have been subject to tax on unrelated business taxable income, subject to specified exceptions, modifications, and special computational rules.

In its press release on the hearings dated May 14, 1987, the Subcommittee stated that the hearings are intended to develop information to assist in determining whether the present-law rules and underlying policy considerations are appropriate. The press release notes that there has been no comprehensive review of the unrelated business income tax rules since 1969, and that "there are many unanswered questions about the scope and nature of tax-exempt organizations' income-producing activities, the administration of the unrelated business income tax by the Internal Revenue Service and the courts, and the extent of compliance with the law." The release also points out that "to date, little factual or statistical data has been available to the Congress for the purpose of evaluating the effect of the unrelated business income tax."

This pamphlet,[1] prepared in connection with the hearings, contains an overview of the principal statutory and regulatory provisions of the unrelated business income tax (Code secs. 511–514).

Subcommittee framework for review

In a press release on the hearings issued by the Committee on Ways and Means dated September 12, 1986, the following questions were listed to set forth the Subcommittee's framework for review of the tax treatment of income-producing activities of exempt organizations, the impact of present-law rules on both tax-exempt organizations and for-profit businesses, and IRS application of, and taxpayer compliance with, the law.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation *Overview of the Unrelated Business Income Tax on Exempt Organizations* (JCS–16–87), June 20, 1987.

I. Profile of Tax-Exempt Organization Activities:

A. What types of income-producing activities—whether considered "active" or "passive"—are carried on by tax-exempt organizations, and how much revenue is produced by such activities? Do different types of tax-exempt organizations tend to engage in different types of investment, commercial, or entrepreneurial activities?

B. How and why have the type, nature, and extent of such income-producing activities changed since 1950? What are the future trends?

C. Are tax-exempt organizations and for-profit businesses competing in the same income-producing activities?

1. To what extent do tax-exempt organizations engage in income-producing activities that are being, or could be, carried on by taxable businesses?

2. To what extent do taxable businesses engage in income-producing activities that traditionally have been performed by tax-exempt organizations?

3. Has renewed concern about competition between tax-exempt and for-profit organizations arisen because tax-exempt organizations are moving into innovative revenue-raising techniques or because traditional tax-exempt organization activities have recently become profitable?

D. To what extent are tax-exempt organizations engaging in commercial activities with for-profit businesses through joint ventures, limited partnerships, or other means? Is the participation of tax-exempt organizations in such commercial ventures inconsistent with their exempt status?

E. To what extent, if any, do current income-producing activities of exempt organizations relate to Federal budget cuts or other government policies?

II. The Purpose of the Law and Its Administration by the Internal Revenue Service and the Courts:

A. What purposes do the unrelated business income tax rules serve? Are these goals being met?

B. Are the "relatedness" and "trade or business" tests appropriate and administrable? What is the relationship between the extent of an organization's related or unrelated trade or business activities and its eligibility for exempt status?

C. What rationales underlie the various exceptions and modifications which permit tax-exempt organizations to engage in certain income-producing activities without taxation? For example, should endowment income be exempt from tax?

D. How is the law relating to unrelated business income being interpreted? Has interpretation of the law changed over time?

E. How does the Internal Revenue Service determine whether a tax-exempt organization's activity generates unrelated business income?

F. Are the current rules unduly burdensome or unreasonably restrictive for tax-exempt organizations?

G. Do the present-law rules permit unfair competition by exempt organizations? If so, how should the rules be changed?

III. Compliance with the Unrelated Business Income Tax:

A. Does the Internal Revenue Service have an adequate, well-balanced enforcement program in this area?

B. What portion of income subject to the unrelated business income tax is reported by recipient organizations on Form 990–T?

C. Can tax-exempt organizations that do not report or [that] mischaracterize unrelated business income be readily identified?

D. Are the Forms 990 and 990–T adequate to identify the type of income-producing activity, the degree of "relatedness" of an activity to an organization's tax-exempt purpose, and other compliance issues?

BACKGROUND AND PRESENT LAW ON UNRELATED BUSINESS INCOME TAX

A. Background and Statutory History

Revenue Act of 1950

In the Revenue Act of 1950, the Congress enacted a tax on the unrelated trade or business income of certain otherwise tax-exempt organizations. Under the 1950 statute, the tax applied to charitable organizations (other than churches), trade associations, labor unions, and certain other categories of tax-exempt organizations.

Prior to enactment of the unrelated business income tax (the UBIT), an organization otherwise qualifying for exempt status—e.g., an organization that was organized and operated exclusively for charitable purposes—could receive tax-free earnings from operating a business so long as the business earnings were used to carry out the organization's exempt purposes.[2] Under this "destination of income" test, large businesses owned by tax-exempt organizations could operate on a tax-free basis; thus, for example, the business was able to use all its earnings for expansion, not just after-tax earnings.

The legislative history of the 1950 Act states that "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition." [3] The legislation did not deny tax-exempt status (if otherwise available) solely because the organization carried on unrelated active business enterprises, but "merely imposes the same tax on income derived therefrom as is borne by their competitors." [4] Court decisions have cited the legislative history of the 1950 Act as reflecting that "the undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed." [5]

The 1950 Act also explicitly provided that no organization that is operated primarily for the purpose of carrying on a trade or business (subject to certain exceptions) for profit shall be tax-exempt merely because all its profits are payable to tax-exempt organizations. This rule overturned the "destination of income" test and makes a "feeder" organization, "which obviously is in direct competition with other taxable businesses," [6] fully taxable. Thus, the

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[2] *See*, e.g., *Trinidad* v. *Sagrada Orden de Predicadores*, 263 U.S. 578 (1924); *C.F. Mueller Co.* v. *Comm'r*, 190 F.2d 120 (3d Cir. 1951); *Roche's Beach, Inc.* v. *Comm'r*, 96 F.2d 776 (2d Cir. 1938).

[3] H. Rpt. No. 2319, 81st Cong., 2d Sess. 36 (1950); Sen. Rpt. No. 2375, 81st Cong., 2d Sess. 28 (1950).

[4] H. Rpt. No. 2319, *supra* n. 3, at 37; Sen. Rpt. No. 2375, *supra* n. 3, at 29.

[5] *See, e.g., U.S.* v. *American Bar Endowment*, 106 S.Ct. 2426 (1986); *U.S.* v. *American College of Physicians*, 106 S.Ct. 1591 (1986) ("Congress perceived a need to restrain the unfair competition fostered by the tax laws").

[6] H. Rpt. No. 2319, *supra* n. 3, at 41; Sen. Rpt. No. 2375, *supra* n. 3, at 35.

tax treatment of unrelated trade or business income is basically the same whether the trade or business activity is conducted directly by the organization or through a "feeder" subsidiary.

In interpreting the UBIT provisions, some court decisions have focused on the presence or absence of competition between a tax-exempt organization and taxable entities engaged in similar activities, or have inquired whether the exempt organization carried on the activity in a commercial manner.[7] Other court decisions have taken the view that the UBIT is not limited to situations where some specific aspect of unfair competition can be shown to have occurred; these decisions note that the statute is not formulated in terms of unfair competition, but in terms of "extracting the same revenue from businesses operated by exempt organizations as that levied upon similar businesses operated by nonexempt entities."[8] In this view, the UBIT has both revenue and equitable objectives.

Tax Reform Act of 1969

In the Tax Reform Act of 1969, the Congress extended the UBIT to all organizations that are exempt from Federal income tax under section 501(a), except certain U.S. instrumentalities created and made tax-exempt by a specific Act of Congress.[9] As originally enacted, the UBIT had applied only to charitable, educational, religious, and other organizations tax-exempt under Code section 501(c)(3), other than churches; labor and agricultural organizations (sec. 501(c)(5)); trade associations (sec. 501(c)(6); qualified pension and profit-sharing trusts (sec. 401); and certain other types of tax-exempt entities. However, by 1969 the Congress found that many other categories of exempt organizations—including churches, social clubs, and fraternal beneficiary societies—had begun "to engage in substantial commercial activity."[10] The Congress concluded that there was no justification to tax (for example) a university or hospital on income from an unrelated trade or business, but not to tax a church or social club on income from the same types of activities.

In the case of social clubs (sec. 501(c)(7)) and voluntary employee beneficiary associations (sec. 501(c)(9)), the 1969 Act provided that the UBIT applies to all income of the organization other than exempt function income, such as membership dues. A principal effect of this rule is to subject the investment income of the club or VEBA to the UBIT. The legislative history reflects that since such entities are granted exempt status so that their members may join together to provide social facilities or other personal benefits with-

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[7] *See, e.g., Hope School* v. *U.S.*, 612 F.2d 298 (7th Cir. 1980); *Hill Family Foundation* v. *U.S.*, 347 F.Supp. 1225 (D. Minn. 1972); *Greene County Medical Society Foundation* v. *U.S.*, 345 F.Supp. 900 (W.D. Mo. 1972); *Disabled American Veterans* v. *U.S.*, 650 F.2d 1178 (Ct. Cl. 1981).

[8] *See, e.g., Louisiana Credit Union League*, v. *U.S.*, 693 F.2d. 525 (5th Cir. 1982); *Clarence LaBelle Post No. 217* v. *U.S.*, 580 F.2d 270 (8th Cir. 1978); *Disabled American Veterans* v. *U.S.*, *supra* n. 7, at 1187; *Carolinas Farm & Power Equipment Dealers Assoc.* v. *U.S.*, 699 F.2d 167 (41a Cir. 1983); *Smith-Dodd Businessman's Assoc.* v. *Comm'r*, 65 T.C. 620 (1975). *See* also *U.S.* v. *American Bar Endowment, supra*, n. 5, referring to "potential for unfair competition" resulting from an insurance program of a tax-exempt organization even though the trial court had failed to identify any taxable entities actually competing with the exempt organization.

[9] The UBIT also applies to certain State colleges and universities and their wholly owned subsidiaries (sec. 511(a)(2)).

[10] H. Rpt. 91-413 (Pt. 1), 91st Cong., 1st Sess. 47 (1969); Sen. Rpt. 91-522, 91st Cong., 1st Sess. 67 (1969).

out tax consequences, the Congress concluded that the tax exemption should be limited to membership receipts. If investment income could be earned tax-free, the members of such entities would receive personal benefits out of tax-free funds.[11]

In addition to making other modifications to the UBIT (including enacting rules relating to the treatment of advertising income), the 1969 Act also broadened the prior-law rules relating to income earned by an otherwise exempt organization from debt-financed property. Under the prior rules, tax-exempt organizations had been able to utilize their exempt status to buy businesses and investments on credit, frequently at what was more than the market price, while contributing little or nothing to the transaction other than their tax exemption.[12] The 1969 Act provided generally that any income of an exempt organization derived from debt-financed property, if unrelated to exempt functions, is subject to the tax in the proportion in which the property is financed by the debt (see F, below).

Subsequent legislation

While the Congress has not engaged in an overall reexamination of the principal provisions of the UBIT since 1969, subsequent legislation has modified the UBIT in various respects. These modifications have included providing exclusions from the UBIT (in the case of specified categories of exempt organizations) for income from (i) qualified trade show, convention, or State fair activities; (ii) providing certain hospital services; (iii) conducting bingo games; (iv) engaging in telephone pole rentals; (v) distribution of low-cost articles in soliciting charitable contributions; and (vi) certain exchanges or rentals of member or donor mailing lists. Other modifications have related to the debt-financed property rules, insurance activities of exempt organizations, and nonexempt function income of qualified trusts that are part of plans for payment of supplemental unemployment compensation benefits or for group legal services.

Effect of unrelated activities on exempt status

As noted above, in enacting the unrelated business income tax, the Congress did not preclude an organization from qualifying for tax-exempt status merely because it carries on a trade or business that is considered unrelated to its exempt purpose, provided the organization meets the requirements for exemption under the Code. For example, a charitable, educational, or religious organization may qualify for tax-exempt status under Code section 501(c)(3) if it is organized and operated exclusively for charitable, etc. purposes—i.e., only if the organization "engages primarily in activities which accomplish one or more" such purposes, and only if not "more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[13] Even though the organization operates a trade or business as a substantial part of its activities, the organization may qualify for section 501(c)(3) status "if the operation of such

[11] H. Rpt. 91-413 (Pt. 1), *supra* n. 10, at 48; Sen. Rpt. 91-552, *supra* n. 10, at 71.
[12] H. Rpt. 91-413 (Pt. 1), *supra* n. 10, at 44-45; Sen. Rpt. 91-552, *supra* n. 10, at 62-63.
[13] Treas. Reg. sec. 1.501(c)(3)-1(c).

trade or business is in furtherance of" its exempt purposes and "if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. . . ." [14]

B. Elements of an Unrelated Trade or Business

In general

Subject to specified exceptions, modifications, and special computational rules, an activity of an otherwise tax-exempt organization generates gross income for purposes of the unrelated business income tax if (1) the income is derived from a trade or business, (2) the trade or business is regularly carried on by the organization, and (3) the conduct of the trade or business is not substantially related (aside from the organization's need for revenues or the use it makes of such revenues) to the organization's performance of its tax-exempt functions (secs. 512(a), 513(a); Treas. Reg. sec. 1.513-1(a)).

Definition of trade or business

General rule

In general, any activity of an exempt organization that is carried on for the production of income from the sale of goods or the performance of services, or any other activity to produce income that constitutes a trade or business within the meaning of section 162, constitutes a trade or business for purposes of the UBIT.[15] The Treasury regulations state that any such activity that is not substantially related to the performance of the organization's exempt functions "presents sufficient likelihood of unfair competition to be within the policy of the tax", inasmuch as "the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations on the same tax basis as the nonexempt business endeavors with which they compete."[16]

On the other hand, the tax does not apply to an activity "that does not possess the characteristics of a trade or business within the meaning of section 162" (allowing deductions to nonexempt taxpayers for trade or business expenses), "since the organization is not in competition with taxable organizations" with respect to that activity. For example, the regulations state that the tax does not apply with respect to the activity of sending out low-cost articles incidental to soliciting charitable contributions. The latter rule in the regulations has been supplanted by a more detailed statutory rule enacted in the Tax Reform Act of 1986 (Code sec. 513(h)).

Fragmentation rule

The statute and regulations provide that activities carried on for the production of income from the sale of goods or the performance of services from which a particular amount of gross income is derived constitute a trade or business even though carried on within a larger aggregate of similar activities or other endeavors that may

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[14] Treas. Reg. sec. 1.501(c)(3)-1(e)(1).
[15] Sec. 513(c); Treas. Reg. sec. 1.513-1(b). *See U.S.* v. *American Bar Endowment, supra*, n. 5.
[16] Treas. Reg. sec. 1.513-1(b).

be related to the organization's exempt purposes.[17] If an activity carried on for profit constitutes an unrelated trade or business, no part of the activity is to be disregarded merely because it does not result in profit.[18]

Under this fragmentation rule, each component part of revenue-producing activities is to be examined separately to determine whether it gives rise to unrelated business income. For example, the regulations provide that advertising activities do not lose their identity as a trade or business even though published in educational materials; thus, income from advertising generally is treated as unrelated business income even if publication and sale of the magazine by the exempt organization may qualify as related educational activities.[19]

The fragmentation rule also applies to the sale of merchandise by an exempt organization. Accordingly, if a museum operates a gift shop, each item sold will be tested separately against the definition of an unrelated trade or business, and gross income from those items that do not qualify as substantially related to the museum's educational purposes constitutes unrelated business income.[19a]

Regularly carried on test

Even if an exempt organization conducts an unrelated trade or business, the income therefrom is not subject to the UBIT unless the activity is "regularly carried on" by the organization (sec. 512(a)). This test looks to the frequency and continuity of the income-producing activities, and the manner in which the exempt organization conducts the activities as compared with the manner in which commercial activities are normally pursued by taxable businesses. In light of the purpose of the tax "to place exempt organization business actitivies upon the same tax basis as the nonexempt business endeavors with which they compete," specific business activities of an exempt organization ordinarily are deemed to be regularly carried on "if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[20]

Under these rules, an organization does not trigger the UBIT if it conducts for a brief period during the year an income-producing activity of a kind that taxable businesses normally conduct throughout the year. For example, a hospital auxiliary could operate a sandwich stand at a two-week State fair once a year without subjecting the income to the tax. Likewise, income derived from infrequent, intermittent income-producing activities, such as the conduct of an annual dance or similar fund-raising event for charity,

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[17] Sec. 513(c); Treas. Reg. sec 1.513-1(b).

[18] *Id.*

[19] *See U.S.* v. *American College of Physicians, supra* n. 5, in which the Supreme Court rejected an IRS argument that the Congress intended a blanket rule requiring the taxation of income from all commercial advertising in tax-exempt professional journals without specific analysis of the circumstances. In the particular case at issue, however, the Court concluded, based on the trial court's findings of fact, that the UBIT applied to income earned by the American College of Physicians from selling commercial advertising space in its professional journal, The Annals of Internal Medicine.

[19a] *See*, e.g., Rev. Rul. 73-105, 1973-1 C.B. 264.

[20] Treas. Reg. sec. 1.513-1(c).

is not treated as subject to the tax. However, if income-producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of a trade or business.[21]

Substantially related test

In general

Even if a tax-exempt organization regularly carries on a trade or business, the income from that activity is subject to the UBIT only if the activity is unrelated to the basis for the organization's tax-exempt status--i.e., only if the activity is not substantially related (other than through the production of funds) to the purposes for which the organization's exemption is granted.[22] Thus, this requirement necessitates examining whether there is a causal relationship between the production or distribution of the goods, the performance of the services, or other trade or business activity, and the accomplishment of the organization's exempt purposes.

The regulations provide that to meet the "substantially related" test, the business activity must "contribute importantly" to the accomplishment of the organization's exempt purposes. Whether this test is met depends in each case on the facts and circumstances involved.[23] Accordingly, numerous cases, published revenue rulings, and private letter ruling have addressed a host of differing fact situations in applying this test.

In determining whether business activities contribute importantly to accomplishing exempt purposes, the regulations weigh the size and extent of the activities against the nature and extent of the exempt function which they are said to serve. Thus, if an organization derives income from activities that are in part related to the performance of its exempt functions, but that are conducted on a larger scale than reasonably necessary to perform such functions, the income attributable to that portion of the activities exceeding the exempt function needs constitutes unrelated business income.[24]

Certain applications of test

The regulations provide that gross income derived from charges for the performance of exempt functions is not subject to the UBIT. For example, the regulations state that the UBIT does not apply to admission charges for performances by students of a tax-exempt performing arts school, or to fees charged by a labor union to members for refresher training courses and related materials. Similarly, gross income derived from the sale of products resulting from the performance of exempt functions is not subject to UBIT, such as income from sale of articles made by handicapped individuals as part of the activities of a tax-exempt rehabilitation organization.[25]

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[21] *Id.*
[22] Sec. 513(a); Treas. Reg. sec. 1.513-1(d).
[23] Treas. Reg. sec. 1.513-1(d).
[24] *Id.*
[25] Treas. Reg. sec. 1.513-1(d)(4).

However, the UBIT may apply to income generated by the exploitation in commercial endeavors of good will or other intangibles arising out of exempt-function activities. For example, the regulations state that payments by an advertising agency to a tax-exempt trade association for the mailing of commercial advertising materials to the association's members constitutes income from an unrelated trade or business. Similarly, the UBIT applies with the respect to income generated by a tax-exempt scientific organization in exploiting its research reputation by selling endorsements of commercial laboratory equipment.[26]

C. Excluded Activities

The Code provides that unrelated trade or business activities subject to the UBIT do not include the following.

Volunteer work.—The tax does not apply to income from an activity in which substantially all the work is performed without compensation (sec. 513(a)(1)). For example, the regulations provide that this exception would apply to income earned by a tax-exempt orphanage from operating a retail store open to the general public if substantially all the work in operating the store is done by unpaid volunteers.

Thrift shops.—The tax does not apply to income from the sale of merchandise substantially all of which has been received by the organization as gifts or contributions (sec. 513(a)(3)). For example, this exception applies to income earned by a thrift shop operated by a tax-exempt organization to which individuals desiring to benefit the organization contribute old clothes or other items to be sold to the general public, with the proceeds going to the exempt organization.

Member convenience.—The tax does not apply to income earned by a tax-exempt charity or by a State college or university from a trade or business carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees (sec. 513(a)(2)). The regulations provide that this exception applies, for example, to revenues earned by a college from operating a laundry for cleaning students' clothing or dormitory linens.

Qualified trade show, State fair, etc. activities.—The tax does not apply to income derived from certain convention or trade show activities at which members of the sponsoring orginization sell products or services, or at which suppliers to the sponsoring organization's members sell products or services related to the organization's exempt activities (sec. 513(d)). This exception applies in the case of qualified convention and trade show activities of charitable organizations, social welfare organizations, labor or agricultural organizations, and trade associations. In addition, the UBIT does not apply to income derived from qualified public entertainment activities conducted at an agricultural and educational fair or exposition in the case of charitable organizations, social welfare organizations, and labor or agricultural organizations.

Low-cost articles.—In the case of a tax-exempt organization that is eligible to receive tax-deductible charitable contributions, the tax

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[26] Treas. Reg. sec. 1.513-1(d)(4)(iv).

does not apply to income generated from the distribution of low-cost articles incidental to the solicitation of charitable contributions (sec. 513(h)).

Mailing lists.—The UBIT does not apply to income derived from exchanges or rental of donor or member lists among tax-exempt organizations that are eligible to receive tax-deductible charitable contributions (sec. 513(h)(1)).

Other items.—The statute also provides exceptions from the UBIT for income derived from the furnishing by a hospital of certain administrative and support services, at cost, to small hospitals (sec. 513(e)); certain bingo games not ordinarily carried on by for-profit organizations (sec. 513(f)); and certain rentals by mutual or cooperative telephone and electric companies of poles that carry electrical or telephone wires (sec. 513(g)).

D. Excluded Income

The statute excludes the following types of income from the definition of unrelated business taxable income (sec. 512(b)). Deductions that are directly connected with excludable income also do not enter into computation of the UBIT.

General rule.—The UBIT generally does not apply to dividends, interest, royalties (including overriding royalties), annuities, certain rents, gains on the disposition of property (other than inventory property), gains on the lapse or termination of securities options written by the organization in connection with its investment activities, and amounts received in connection with certain securities loans. (As described below, special computational rules apply in the case of investment income and other nonexempt function income of social clubs and certain other exempt organizations.)

The exclusions listed above for investment income and certain other income do not apply to the extent the income is derived from debt-financed property (as described below). In addition, interest, annuities, royalties, and rents derived from 80-percent subsidiaries, or certain other controlled organizations, are treated as unrelated business income generally in proportion to the income of such controlled organization that would be subject to the UBIT if derived directly by the tax-exempt organization (sec. 512(b)(13)).

Rents.—The exclusion from the UBIT of rental income applies to rents from real property, or from a lease of real and personal property if the rent attributable to the personal property constitutes an incidental amount of the total rent (sec. 512(b)(3)). Rents attributable to personal property that amount to more than 10 percent of the total rents due under the lease do not qualify as incidental. Also, neither rents attributable to real property nor rents attributable to personal property are excluded from the UBIT if more than half of the total rent under the lease is attributable to personal property, or if the amount of rent depends on the income or profits derived from the leased property (other than a fixed percentage of receipts or sales).

Research.—The statute also excludes certain income from research from the UBIT; for this purpose, research does not include activities of a type ordinarily carried on in commerce or industry,

such as ordinary product testing or design.[27] In the case of a college, university, or hospital, or an organization operated primarily to carry on fundamental research the results of which are freely available to the general public, income from research performed for any person is not subject to the UBIT (secs. 512(b)(8), (b)(9)). Other exempt organizations may exclude from the UBIT income from research performed for the United States, its agencies and instrumentalities, or for any State or political subdivision thereof (sec. 512(b)(7)).

In a 1976 ruling,[28] the IRS set forth factors to be considered in determining whether income from commercially sponsored research conducted by a scientific research organization is subject to the UBIT. A scientific organization may qualify for tax-exempt status under section 501(c)(3) if it conducts scientific research in the public interest (e.g., if the research results are made available to the public on a nondiscriminatory basis). Under the ruling, if the results of commercially sponsored projects generally are published in such form as to be available to the interested public within a reasonably short time after completion, the organization is treated as engaging in scientific research in the public interest, even though the sponsor retains ownership rights in the research results. By contrast, if the organization agrees to withhold publication beyond the time reasonably necessary to obtain patents, or agrees to forego publication completely, the ruling holds that income from conducting the commercially sponsored research is subject to the UBIT.

E. Special Rules; Computation of UBIT Liability

Special rules for social clubs, VEBAs, etc.

The statute provides special rules for computing the unrelated business taxable income of social clubs (sec. 501(c)(7)), voluntary employee beneficiary associations (sec. 501(c)(9)), supplemental unemployment compensation benefit trusts (sec. 501(c)(17)), and group legal service organizations (sec. 501(c)(20)). Under these rules, the UBIT applies to all gross income other than exempt function income, reduced by directly related deductions (sec. 512(a)(3)).

The term exempt function income includes dues, fees, charges or similar amounts paid by the organization's members for goods, facilities, and services that form the basis of the organization's tax-exempt status. In addition, exempt function income includes amounts set aside (1) for charitable purposes (as where a national organization of college fraternities or sororities sets aside amounts for scholarships) or (2), except in the case of social clubs, to provide for the payment of life, sick, accident, or other benefits. (However, amounts set aside for such exempt purposes become subject to the UBIT to the extent actually used for other purposes.) Finally, the UBIT is not imposed on gain from sales of assets used in the performance of the organization's exempt functions (as where a social club sells its clubhouse) to the extent the proceeds are reinvested in assets used for those functions (as where the proceeds of a sale fit-

[27] Treas. Reg. Sec. 1.512(b)-1(f)(4).
[28] Rev. Rul. 76-296, 1976-2 C.B. 141.

ting the above description are used to build a larger clubhouse) within a specified period.

Veterans organizations

In the case of a veterans organization (sec. 501(c)(19)), the UBIT does not apply to amounts paid for life, sick, accident, or health insurance for members and dependents that are set aside to pay for insurance benefits or for charitable purposes (sec. 512(c)(4)). However, amounts set aside for such purposes but actually used for other purposes are subject to the UBIT.

Certain insurance activities

The Tax Reform Act of 1986 enacted rules relating to certain insurance activities of tax-exempt organizations. Under these rules, a charitable or social welfare organization is tax-exempt only if no substantial part of its activities consists of providing commercial-type insurance. If the organization does provide such insurance without violating this prohibition, its insurance activity is treated as an unrelated trade or business; however, the income is taxed under the rules relating to insurance companies rather than the general UBIT rules (sec. 501(m)).

The Congress also directed the Treasury to study and report on the appropriate tax treatment of fraternal beneficiary organizations (sec. 501(c)(8)) that engage in certain insurance activities.[29]

Deductions

The Code provides the following deduction rules for computing the UBIT.

Specific deduction.—Each tax-exempt organization is allowed a specific deduction of $1000 (sec. 512(b)(12)). Local units of churches, associations of churches, and religious orders each are entitled to a specific deduction equal to the lesser of $1000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.

Net operating losses.—The net operating loss (NOL) deduction applies to the computation of the UBIT (sec. 512(b)(6)). Only income and deduction items not excluded from the UBIT are taken into account for these purposes, and preceding years in which the organization was not subject to the exempt organization rules are ignored in computing NOLs, NOL carrybacks, and NOL carryforwards.

Charitable contributions.—Tax-exempt organizations and State colleges and universities generally are entitled to deductions of up to 10 percent of unrelated business taxable income for charitable contributions, whether or not the contributions are related to carrying on of the trade or business (sec. 512(b) (10), (11)).

Computation of tax liability

Exempt organizations other than trusts are taxed on their unrelated business taxable income at the corporate tax rates (sec. 511(a)). Thus, in taxable years beginning on or after July 1, 1987, the UBIT rates are graduated with a maximum rate of 34 percent;

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[29] H. Rpt. 99-426, 99th Cong., 1st Sess. 666 (1985); H. Rpt. 99-841 (Vol. II), 99th Cong., 2d Sess. 345-46 (1986).

in effect, a flat 34-percent tax applies to organizations with unrelated business taxable income exceeding $335,000.

Tax-exempt trusts are subject to UBIT at the trust income tax rates. Thus, beginning in 1988, tax-exempt trusts are taxed on their unrelated business taxable income at rates up to 28 percent; in effect, a flat 28-percent tax applies when such income exceeds $26,000.

The alternative minimum tax applies with respect to unrelated business taxable income to the extent exceeding the regular UBIT liability.

F. Debt-Financed Property Rules

In general, unrelated business taxable income does not include certain types of income, such as interest, dividends, rents, royalties, and certain gains and losses from the sale of property. Under section 514, however, such items may be includible in unrelated business taxable income to the extent derived from debt-financed property the use of which is not substantially related to the organization's exempt purposes.[30]

Section 514 first was enacted in 1969, in the aftermath of a Supreme Court case [31] upholding a transaction in which, through the use of a sale-leaseback, a tax-exempt organization in effect was able to "sell" the use of its tax exemption to an unrelated third party business without disrupting the third party owners' control of the business. The Congress concluded that such transactions presented particular problems when debt-financed, because in such circumstances an exempt organization could obtain nominal ownership of a business without any commitment of its own funds.

In order for income from an item of property to be includible under section 514, the property must be debt-financed; i.e., there must be acquisition indebtedness with respect to that property during the taxable year. For this purpose, acquisition indebtedness includes debt incurred upon acquisition; debt incurred prior to the acquisition that otherwise would not have been incurred; and debt incurred subsequently if the incurrence was reasonably foreseeable at the time of the acquisition (sec. 514(c)). The statute includes several exceptions to the definition of acquisition indebtedness, including an exception for indebtedness incurred by certain categories of exempt organizations in acquiring or improving real property (sec. 514(c)(9)).

The amount of gross income from an item of debt-financed property that is includible in unrelated business taxable income under section 514 is limited to a percentage reflecting the degree to which such property is debt-financed. For example, if an item of property is 60 percent debt-financed (i.e., acquisition indebtedness is 60 percent of adjusted basis), then 60 percent of the gross income from the property is includible. For purposes of this calculation, both acquisition indebtedness and adjusted basis are calculated on an average basis for the taxable year.

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[30] Other exceptions to the definition of debt-financed property for purposes of section 514 generally resemble exceptions to the scope of unrelated business taxable income applying for purposes of sections 511–513. *See* section 514(b).

[31] *Clay Brown* v. *Comm'r*, 380 U.S. 563 (1965).

Gross income includible under section 514 is reduced by allowable deductions. Such deductions are computed by applying the same percentage used with respect to gross income to deductions directly connected with the debt-financed property or the income therefrom.

G. Reporting and Payment Requirements

Tax-exempt organizations (other than churches) generally must file an annual information return with the IRS (sec. 6033(a)). For most types of organizations described in section 501, the annual filing is made on Form 990. Every organization (including a church) subject to the UBIT is required to file a tax return covering its business income, Form 990-T, if it has gross income from an unrelated trade or business for the taxable year of $1,000 or more.[32] In the case of calendar-year organizations, these returns generally must be filed by May 15 of the following year.

An organization that files Form 990 is required to state whether it had gross income of $1,000 or more from an unrelated trade or business during the year covered by the form, and whether it has filed Form 990-T for the year. If the organization has gross sales or receipts from business activities not reported on Form 990-T, it is required to attach a statement explaining the reasons for not reporting such revenues on Form 990-T.

For taxable years beginning after 1986, tax-exempt organizations must make estimated payments of their UBIT liability under the same estimated tax payment rules that apply to corporate income taxes (sec. 6154(h)).

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[32] Treas. Reg. sec. 1.6012-2(e).